FIL

SUPREME

ANNE P. HUMPHREY,
BERT PATTERSON HUMPHREY
ceased, JOE A. HUMPHREY
Executor, DEANE HUMPHREY, [illegible]
HUMPHREY AND JOE A. HUMPHREY

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE
STATES CIRCUIT COURT OF APPEALS FOR THE
CIRCUIT AND BRIEF IN SUPPORT THEREOF

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SEPTEMBER, 1947

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COMMERCIAL RECORDER, FORT WORTH, TEXAS—9-47-47—50

INDEX

	Pages
Petition for Certiorari	1
Question Presented	2
Statute and Regulations Involved	2
Statement	8
Specification of Errors to be Urged	13
Reasons for Granting the Writ	13
Brief in Support of Petition for Certiorari	17
Opinion Below	17
Jurisdiction	18
Statutes and Regulations Involved	18
Question Presented	18
Statement	18
Specification of Errors to be Urged	19
Summary of Argument	19
Argument	20
Conclusion	24

AUTHORITIES CITED

Pages

Cases:

Hadley Falls Trust Co. v. United States, (CCA 1st—1940); 110 F. 2d 887 14,16,24

Nichols et al v. Commissioner of Internal Revenue; 1 TC 328 15,20

Nichols et al v. Commissioner of Internal Revenue (CCA 6th—1944); 141 F. 2d 870 14,15,16,20,21,24

Statutes:

Internal Revenue Code:

Sec. 22 15,20

Sec. 22(a) 2

Sec. 111(a) 3,23

Sec. 111(b) 3

Sec. 113(a) 3

Sec. 113(b) 3

Sec. 117 20,33

Sec. 117(a) 4,14,20

Sec. 117(b) 4

Sec. 117(c) 5

Sec. 183(a) 6

Sec. 183(b) 6

Treasury Regulations:

Regulation 103
Sec. 19.23(k)-3 7,15,16,19,21,23

No.....

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1947

ANNE P. HUMPHREY, ESTATE OF ALBERT PATTERSON HUMPHREY, Deceased, JOE A. HUMPHREY, Independent Executor, IRENE HUMPHREY, LAYTON HUMPHREY AND JOE A. HUMPHREY,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to The United States Circuit Court of Appeals for the Fifth Circuit

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Anne P. Humphrey, the Estate of Albert Patterson Humphrey, deceased, Joe A. Humphrey, Independent Executor, Irene Humphrey, Layton Humphrey, and Joe A. Humphrey, pray that a Writ of Certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above cause on July 2, 1947, insofar as the same affirmed the decisions of the Tax Court of the United States.

Question Presented

One single question is presented by these proceedings. It is whether the gain realized in 1941 by the

Partnership Joe A. Humphrey Company (includable for taxation in the individual returns of the several partners and their respective spouses) from applying lien notes of Ellis Petroleum Company in partial satisfaction of the price bid by the partnership (a secured creditor) for certain pledged assets of Ellis Petroleum Company, bankrupt, at a lawful sale of such pledged assets, is taxable as ordinary income under the general provisions of Section 22 of the Internal Revenue Code, or whether (as contended by petitioners) under the provisions of Treasury Regulations having the force and effect of law (Sec. 19.23 (k) of Treasury Regulations 103) specifically dealing with the purchase by a creditor of mortgaged or pledged property at a lawful sale thereof, and the provisions of Sec. 117 of the Internal Revenue Code, the resulting gain is taxable at Capital Gain rates. The partnership had no cost or other basis for gain or loss in the aforesaid notes as its entire investment therein had been charged off in a previous taxable year.

Statutes and Regulations Involved

INTERNAL REVENUE CODE (as Amended).

Sec. 22. Gross Income:

(a) General Definition.—"Gross income" includes gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property, whether real or personal growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction

of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Sec. 111. Determination of Amount of, and Recognition of, gain or loss.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determininf gain * * *.

(b) Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Sec. 113. Adjusted Basis for Determining Gain or Loss.

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that * * *

(b) Adjusted basis.—The adjusted basis * * * shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General rule.—Proper adjustment in respect of the property shall in all cases be made—

(A) For expenditures, receipts, losses, or other items properly chargeable to capital account, * * *.

Sec. 117. Capital Gains and Losses.

(a) Definitions.—As used in this chapter—

(1) CAPITAL ASSETS.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or busineess), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1); * * *

(4) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income; * * *

(b) Percentage taken into account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66-2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months.

50 per centum if the capital asset has been held for more than 24 months.

(c) Alternative taxes.—

(1) IN CASE OF NET LONG-TERM CAPITAL GAIN.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain.

(2) IN CASE OF NET LONG-TERM CAPITAL LOSS.—If for any taxable year a taxpayer (other than a corporation) sustains a net long-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is greater than the tax imposed by such sections:

A partial tax shall first be computed upon the net income increased by the amount of the net long-term capital loss, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be he partial tax minus 30 per centum of the net long-term capital loss. * * *

Sec. 183. Computation of Partnership Income.

(a) General Rule.—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b) and (c).

(b) Segregation of Items.—

(1) Capital Gains and Losses.—There shall be segregated the short-term capital gains and losses and the long-term capital gains and losses, and the net short-term capital gain or loss and the net long-term capital gain or loss shall be computed.

(2) Ordinary Net Income or Loss.—After excluding all items of either short-term or long-term capital gain or loss, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income.

TREASURY REGULATIONS 103 (1940):

Sec. 19.23(k)-3. * * * *If Mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser)* for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. In addition, *if the creditor buys in the mortgaged or pledged property, LOSS* or *GAIN is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property.* The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

Accrued interest may be included as part of the deduction only if it has previously been returned as income. (Emphasis supplied).

Statement

Throughout the calendar year 1941, petitioners Anne P. Humphrey and Albert Patterson Humphrey* (husband and wife), Layton A. Humphrey, and Joe A. Humphrey were members of the partnership Joe A. Humphrey Company, which was engaged in the oil business and had its offices in Dallas, Texas. Anne P. Humphrey and Albert Patterson Humphrey, together, had a one-half (½) interest, and Layton A. Humphrey and Joe A. Humphrey each had a one-fourth (¼) interest in the partnership. This partnership kept its books on an accrual basis (R. 118). Irene Humphrey was married to Layton Humphrey on March 21, 1941, and they continued to be husband and wife from that date (R. 119). Under the laws of Texas all of the income and deductions of Anne P. Humphrey and Albert Patterson Humphrey for the year 1941 were the community income and deductions of these two petitioners; and all the income and deductions of Irene Humphrey and Layton Humphrey from and after March 21, 1941, were the community income and deduction of those two petitioners. Joe A. Humphrey was unmarried throughout 1941 (R. 119).

*Deceased.

At December 15, 1939, Joe A. Humphrey Company held notes executed by Ellis Petroleum Company in the aggregate face amount of $63,758.25, secured by mortgage deeds of trust on property owned by debtor corporation. The investment of Joe A. Humphrey Company

in these notes amounted to $42,200.00. (R. 122). On or about December 15, 1939, a proceeding was filed in the United States District Court for the Eastern District of Texas for the corporate reorganization of Ellis Petroleum Company in connection with which that corporation was adjudged bankrupt. In this proceeding the Joe A. Humphrey Company, acting by and through Joe A. Humphrey, one of its partners, filed proof of its claim against Ellis Petroleum Company for the aforesaid indebtedness in the amount of $63,758.25. The investment of Joe A. Humphrey Company in these notes, amounting, as aforesaid, to $42,200.00, was charged off by Joe A. Humphrey Company in its income tax return for the calendar year 1939 (filed early in 1940) as worthless and uncollectible, with a resulting tax benefit. The amount charged off represented the entire basis for gain or loss of Joe A. Humphrey Company in the notes (R. 122, 123), and thereafter the basis for gain or loss of such notes was zero.

On September 5, 1941, on petition of the trustee in bankruptcy, and the application of the Mercantile National Bank at Dallas, Texas (a secured creditor), before there had been any adjudication as to the validity of the various creditors' claims filed in the Ellis Petroleum Company bankruptcy proceeding, or the respective priorities of such claims, the referee in bankruptcy entered an order of sale directing the trustee to sell at public auction on the 15th day of October, 1941, certain described property of the Ellis Petroleum Company, bankrupt. The order of sale directed that

the property be sold free and clear of all liens, claims and interest of every character (except that certain equipment was to be sold subject to the rights of International Derrick & Equipment Company), and that all liens and claims of every character against the property were to be transferred to the proceeds of the sale, without determination by the Court of the validity and priority of such claims. It was further directed that the sale was to be made for cash, providing, however, "that in the case of any lienholder whose lien is inferior to the lien of the Mercantile National Bank at Dallas, a bid of not less than $25,000.00 cash, together with an additional cash sum not less than the unpaid balance of the claim of the Mercantile National Bank at Dallas, and all other liens prior to the bidding lienholders claim, shall be deemed a cash bid for the total amount of all such cash and credit." (R. 123).

At the sale so authorized, Joe A. Humphrey Company was represented by Joe A. Humphrey and Lanham Crowley, the latter being attorney for the partnership. The bidding started at about $135,000.00 for the property offered for sale, and the property was ultimately bid in, jointly, by Joe A. Humphrey Company and McClanahan & Venable (holders of obligations of Ellis Petroleum Company in the face amount of $45,725.16, of equal dignity and on a parity with the lien securing the notes held by Joe A. Humphrey Company (R. 186, 187)), for a final bid price of $160,000.00. There were other bidders at this public auction, at least one of whom did not hold any obligations of

the Ellis Petroleum Company (R. 124). After such bid had been made, the referee in bankruptcy required Joe A. Humphrey Company, and McClanahan & Venable, the successful bidders, to pay $10,155.87 in cash on their said bid price, in addition to the $25,000.00 in cash required in the Notice of Sale. (R. 168).

When this additional cash payment was demanded of them by the referee in Bankruptcy, Joe A. Humphrey Company and McClanahan & Venable attempted to withdraw their bid, but the referee took the position that he had authority under the bankruptcy law to compel them to comply with the bid and pay the amount thereof in any form he might require, and refused them the right to withdraw the same. They protested to the referee informally, but took no legal action to set aside his action in the premises. The sale was confirmed on November 8, 1941, and on December 3, 1941, the property was conveyed to Joe A. Humphrey Company, to the extent of sixty per cent (60%) and to McClanahan & Venable, to the extent of 40%. Its share, $96,000.00, of the total bid price for the property of $160,000.00, was paid by Joe A. Humphrey Company (R. 124, 163, 217), as follows:

Cash—required by the Notice of Sale	$15,000.00
Cash—additional amount, required by the Trustee	6,093.52
Paid Mercantile National Bank in cash	27,475.44
Paid by applying to the bid price notes of Ellis Petrolem Company at face	

amount (R. 163) 47,431.04

Total $96,000.00

By a later settlement agreement (reached in 1942) the share of Joe A. Humphrey Company, or $6,093.52, in the cash totaling $10,155.87 that the successful bidders had been required to pay, in addition to the cash required in the Notice of Sale, was returned to it (R. 124).

The notes of Ellis Petroleum Company involved had been held by Joe A. Humphrey Company for more than twenty-four months (R. 124).

With respect to the foregoing transactions, the Commissioner of Internal Revenue included in the gross income of Joe A. Humphrey Company, as ordinary income, the sum of $63,758.25, with the following explanation:

> "There has been included in the gross income of the Joe A. Humphrey Company the sum of $63,758.25, representing the credit given the partnership in connection with the purchase by the Joe A. Humphrey Company of properties from the Ellis Petroleum Corporation. Said sum represents the face value of notes written off the books by the partnership and allowed as a deduction in a prior year, together with other charges, for which the partnership received a tax benefit" (R. 104).

Before the Tax Court, the Commissioner conceded that the maximum extent of the income involved in

this issue was $47,434.04 instead of the $63,758.25 determined by him (R. 138). The Tax Court sustained the determination of the Commissioner, except to the extent that he thus conceded error, and held that Joe A. Humphrey Company derived $47,431.04 ordinary income from the transaction. The Circuit Court of Appeals affirmed.

Specification of Errors To Be Urged

The Circuit Court of Appeals erred:

(1) In the holding and deciding that Joe A. Humphrey Company and the partners in such partnership (and their respective spouses) realized ordinary income in 1941 from the disposition of obligations of Ellis Petroleum Company in that year.

(2) In failing to hold and decide that the gain realized in 1941 by Joe A. Humphrey Company and the partners thereof from the disposition of obligations of Ellis Petroleum Company constituted a long-term capital gain taxable under the provisions of Section 117 of the Internal Revenue Code.

Reasons for Granting the Writ

The writ should be granted because the holding of the Court below completely ignored and failed to apply applicable provisions of the Internal Revenue Code, and of Treasury Regulations of long standing having the force and effect of law; because the holding of the

court below is in direct conflict with the legal principles applied by the United States Circuit Court of Appeals for the Sixth Circuit in *Nichols, et al, v. Commissioner of Internal Revenue*, 141 F. 2d 870, decided April 5, 1944, and is further in conflict with the legal principles applied by the United States Circuit Court of Appeals for the First Circuit in *Hadley Falls Trust Company v. United States*, 110 F. 2d 887, decided March 29, 1940; and because the Court below decided an important question of federal law which has not been, but which should be, decided by this Court.

It is conceded by Petitioners that in 1941 the partnership Joe A. Humphrey and the individual partners thereof realized "gross income" within the meaning of Section 22 of the Internal Revenue Code (as amended) in the amount of $47,431.04 through the disposition of notes of Ellis Petroleum Company. The statutory provision in question, viz, Section 22 of the Internal Revenue Code, is so general as to render an interpretative regulation appropriate. Moreover, it does not deal with the question whether such "Gross Income" is taxable as ordinary income or as a capital gain.

If this transaction qualifies as a "sale or exchange," under the provisions of Section 117 of the Internal Revenue Code, the resulting gain is taxable as a capital gain instead of as ordinary income.

Since 1926 the Treasury Regulations have repeatedly classified a transaction of the type here involved as

an exchange of mortgage notes for land. Section 19.23(k)-3 of Treasury Regulations 103 (1940), which was in effect throughout the year 1941, so classifies such a transaction. In the *Appeal of Elliott S. Nichols and Anne D. Nichols*, 1 TC 328, the Tax Court of the United States, held that where mortgaged or pledged property was lawfully sold and the creditor bought in such mortgaged or pledged property by applying obligations of the debtor to the purchase or bid price of the property, the transaction constituted an exchange of the mortgage notes for the land and the resulting loss was a capital loss, the deductibility of which was governed and limited by the provisions of Section 117 of the Revenue Act of 1932, the counterpart of Section 117 of the Internal Revenue Code. The Circuit Court of Appeals for the Sixth Circuit in *Nichols, et al, v. Commissioner of Internal Revenue, supra*, sustained this holding but reversed the holding of the Tax Court that the principal amount of the obligations exchanged and the interest thereon should be segregated and, for tax purposes, dealt with separately. In the case at bar the Tax Court and the Circuit Court of Appeals for the Fifth Circuit, looking to Sec. 22 Internal Revenue Code alone, held that Joe A. Humphrey Company and the individual partners thereof realized ordinary income, and not capital gain, from the transfer of those obligations of Ellis Petroleum Company that were applied to the bid price of mortgaged property of the debtor bought in by such creditor at a lawful sale thereof. We respectfully assert that such holding was erroneous.

Because of the importance of the question here involved as to the scope and effect of Section 19.23(k)-3 of Treasury Regulations 103, because of conflicting decisions of different judges of Tax Court of the United States on the same question, and because of the conflict between the principles applied in the decision of the Court below in the instant proceeding with those applied by the Sixth Circuit Court of Appeals in *Nichols, et al, v. Commissioner of Internal Revenue, supra,* and *Hadley Falls Trust Company v. United States, supra,* it is believed that the writ should issue to the end that there may be an authoritative decision of this Court upon the question involved.

WHEREFORE, it is respectfully submitted that the petition should be granted.

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No.....

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1947

ANNE P. HUMPHREY, ESTATE OF ALBERT PATTERSON HUMPHREY, Deceased, JOE A. HUMPHREY, Independent Executor, IRENE HUMPHREY, LAYTON HUMPHREY AND JOE A. HUMPHREY.

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Brief in Support
of
Petition for Writ of Certiorari to The United States Circuit Court of Appeals for the Fifth Circuit

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Opinions Below

The opinion of the Circuit Court of Appeals is reported at .....F. 2d ..... The Tax Court of the United States entered its memorandum findings of fact and opinion in these proceedings on January 18, 1946. Such memorandum findings of fact and opinion (R. 115-142) were not published.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered July 2, 1947. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by 43 Stat. 938 (U.S.C., Title 28, Sec. 347).

Statutes and Regulations Involved

The applicable statutes and Treasury regulations are fully set out in the petition for certiorari, at pages 2 to 7, to which reference is hereby made.

Question Presented

The question presented is whether the gain derived by a creditor from the application of obligations of a debtor in payment of the price bid for mortgaged or pledged property of the debtor upon a lawful sale thereof is subject to taxation as a capital gain under the provisions of Treasury Regulations 103, Section 19.23(k)-sions of Treasury Regulations 103, Section 19.23(k)-3, 3, and Section 117 of the Internal Revenue Code (as amended), or whether such gain is taxable as ordinary income under the general provisions of Section 22(a) of the Internal Revenue Code, where the investment of the tax payer in such obligations had been charged off in a prior year.

Statement

The statement of facts contained in the petition for certiorari (pages 8 to 13, supra) sufficiently de-

velops the salient facts. Reference to that statement is hereby made.

Specification of Errors To Be Urged

The Circuit Court of Appeals erred:

(1) In the holding and deciding that Joe A. Humphrey Company and the partners in such partnership (and their respective spouses) realized ordinary income in 1941 from the disposition of obligations of Ellis Petroleum Company in that year.

(2) In failing to hold and decide that the gain realized in 1941 by Joe A. Humphrey Company and the partners thereof from the disposition of obligations of Ellis Petroleum Company constituted long-term capital gains taxable under the provisions of Section 117 of the Internal Revenue Code.

Summary of Argument

(a) The sale by the trustee in bankruptcy on October 15, 1941, of mortgaged or pledged property belonging to Ellis Petroleum Company, a bankrupt, was a lawful sale of mortgaged or pledged property within the purview of Section 19.23(k)-3 of Treasury Regulations 103 (1940). Such property was sold to creditors holding liens against the same, one of whom was Joe A. Humphrey & Company, a partnership. Obligations of the debtor were applied to the purchase or bid price of the property. Since 1926 the Treasury Regulations

have repeatedly classified a transaction of this type as an exchange of the mortgage notes for land. The resulting gain is taxable as a capital gain and not as ordinary income: Section 117 (a), Internal Revenue Code (as amended); *Nichols, et al. v. Commissioner of Internal Revenue*, 1 TC 328; *Nichols, et al, v. Commissioner of Internal Revenue*, 141 F. 2d 870. The Tax Court of the United States and the Circuit Court of Appeals for the Fifth Circuit erred in holding and determining such gain to be taxable as ordinary income.

Argument

Section 22 of the Internal Revenue Code, as amended, requires that there be included in "gross income," among other things, gains, profits, and income derived from dealings in property. This section is undoubtedly broad enough to require that the gain derived in 1941 by Joe A. Humphrey Company from its dealings in notes of Ellis Petroleum Company, which amounted to $47,431.04, be included in gross income. But, Section 22 of the Internal Revenue Code does not provide to what extent the gain so realized shall be recognized for tax purposes, nor the rates at which the recognized gain is to be taxed.

Section 117 of the Internal Revenue Code does prescribe the manner of taxing gains and losses from sales or exchanges of capital assets. The notes of Ellis Petroleum Company held by Joe A. Humphrey Company at the beginning of 1941 constituted capital assets as

that term is defined in Section 117 of the Code. Accordingly, if the disposition made of those notes by Joe A. Humphrey Company in 1941 amounted to a sale or exchange thereof within the purview of Secction 117 of the Code, the resulting profit constituted a capital gain includable in income only to the extent provided in Section 117, and subject to taxation in the manner provided by that Section.

In 1926 a Treasury Regulation reasonably adapted to the administration of the income tax provisions of the Internal Revenue laws, insofar as sales of mortgaged or pledged property were concerned, was promulgated by the Treasury Department. Such Regulation remained substantially unchanged while the pertinent provisions of the Internal Revenue Act were repeatedly enacted. For the year 1941 it appeared as Section 19.23(k)-3 of Treasury Regulations 103 (1940). Under such circumstances the Regulation is to be given the same force and effect as the statute itself. *Nichols v. Commissioner of Internal Revenue*, 141 F. 2d 870.

The Regulation is based upon the theory that where mortgaged or pledged property is lawfully sold, if the creditor buys in the mortgaged or pledged property and applies obligations of the debtor held by him to the purchase or bid price of the property, then to the extent of the obligations so applied, the transaction constitutes the exchange of the obligations of the debtor for the property and, insofar as the income taxing acts are concerned, is to be treated in the same way as any other exchange of property for property.

It is true that the notes of Ellis Petroleum Company held by Joe A. Humphrey Company at January 1, 1941, had no basis for gain or loss in the hands of the partnership because the investment of the partnership therein had been charged off in a prior year. We respectfully assert that insofar as the question here before the Court is concerned, such prior-year charge-off does nothing more than to decrease the amount of the partnership's investment in such notes and correspondingly increase its gain from their disposition. It does not affect the *character* of the transaction, which under the Regulation remains, as it would have been absent such chargeoff, an exchange of notes for property. Such write-off is comparable to the writing off of depreciation sustained with respect to depreciable property, and other deductions of like character effecting basis. There is no provision of law that requires or permits part or all of a capital gain to be taxed as ordinary income merely because the *basis* of property sold or exchanged has been reduced by prior year deductions effecting basis, even though such prior year deductions reduced ordinary income. Only the *amount* and not the *character*, of the gain or loss from the sale or exchange of a depreciated or otherwise charged down capital asset, is affected by such prior year deductions.

The Circuit Court found that the cases cited and relied upon by the Tax Court in its opinion were not

decisive of this case (R. 225). However, it also thought that Sections 111 and 117 of the Internal Revenue Code could not apply to taxpayer's disposition of the notes of Ellis Petroleum Company involved in these proceedings "for they were not sold to a third person but were paid by the debtor through the bankruptcy court out of the proceeds of his property, as the decree of sale expressly states." (R. 225). This finding is directly contrary to stipulated facts (R. 163), and to the express requirement of the regulations that the transaction be deemed an exchange of notes for property, and not treated as an ordinary collection thereof.

Because Treasury Regulations 103, Section 19.23 (k)-3 is preceded by the caption "Uncollectible Deficiency Upon Sale of Mortgaged or Pledged Property" and the first sentences of such regulation permit the charge-off of a taxpayer's investment, if any, in *unapplied* obligations, the Circuit Court of Appeals considered that the Regulation had no application in the case at bar as Joe A. Humphrey Company had no basis for gain or loss with respect to the unapplied obligations of Ellis Petroleum Company remaining on hand after some of such obligations had been applied on the price bid by the partnership for certain pledged property of the debtor sold at lawful sale, as the investment of the partnership in such remaining

notes had been charged off and deducted from income in a prior year and the partnership had nothing more in them to lose.

But we are here dealing with *applied* obligations, not unapplied obligations, and we respectfully assert that in so holding the Circuit Court completely closed its eyes to that portion of the above-referred-to regulation which appears in italics at page 7... of the petition for certiorari herein. Such italicized portion of the cited Regulation is the only part thereof having any application to the particular facts obtaining in the case at bar.

The opinion of the court below, therefore, wholly ignored and failed to apply Treasury Regulations of long standing having the force and effect of law. It is directly in conflict with the principles laid down by the Circuit Court of Appeals for the Sixth Circuit in *Nichols, et al, v. Commissioner of Internal Revenue*, 141 F. 2d 870 (CCA-6th) and *Hadley Falls Trust Company v. United States*, 110 F. 2d 887 (CCA-1st), inclusive.

Conclusion

It is respectfully submitted that the decision below is erroneous; deals with an important question of federal law; conflicts with decisions of other Circuit Courts of Appeal; affirms a decision by a Judge of the Tax Court

of the United States that is directly in conflict with a decision of another Judge of the Tax Court of the United States on the same subject matter; and that the petition for certiorari should be granted and the decision below reversed.

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute and regulations involved	2
Statement	2
Argument	5
Conclusion	10
Appendix	11

CITATIONS

Cases:	
Central Loan & Investment Co. v. *Commissioner*, 39 B. T. A. 981	7
Hadley Falls Trust Co. v. *United States*, 110 F. 2d 887	8, 9
Helvering v. *Midland Ins. Co.*, 300 U. S. 216	10
Malden Trust Co. v. *Commissioner*, 110 F. 2d 751	9
National Bank of Commerce of Seattle v. *Commissioner*, 40 B. T. A. 72, affirmed, 115 F. 2d 875	7
Nichols v. *Commissioner*, 141 F. 2d 870	8, 9
Putnam National Bank v. *Commissioner*, 20 B. T. A. 45, affirmed, 50 F. 2d 158	7
Statutes:	
Internal Revenue Code:	
Sec. 22 (26 U. S. C. 1940 ed., Sec. 22)	7, 11
Sec. 117 (26 U. S. C. 1940 ed., Sec. 117)	13
Miscellaneous:	
H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 69–71 (1942–2 Cum. Bull. 372)	7
I. T. 3159, 1938–1 Cum. Bull. 188	8
S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 79–80 (1942–2 Cum. Bull. 504)	8
Treasury Regulations 62, Art. 51	6
Treasury Regulations 65, Art. 151	6
Treasury Regulations 103:	
Sec. 19.22 (b) (12)–1	14
Sec. 19.23 (k)–1	6, 16
Sec. 19.23 (k)–3	8, 16
Sec. 19.42–1	6, 17

765509—47——1

In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 380

ANNE P. HUMPHREY, ESTATE OF ALBERT PATTERSON HUMPHREY, DECEASED, JOE A. HUMPHREY, INDEPENDENT EXECUTOR, IRENE HUMPHREY, LAYTON HUMPHREY AND JOE A. HUMPHREY, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 115–142) is not officially reported. The opinion of the Circuit Court of Appeals (R. 223–226)[1] is reported at 162 F. 2d 1.

[1] The opinion appearing at these pages of the record is the unanimous opinion of the court below on the issue with respect to which the writ of certiorari is sought. In addition, there was a dissenting opinion in the court below (R. 226–228) on another issue, not involved in the present application for certiorari.

JURISDICTION

The judgment of the Circuit Court of Appeals (R. 228–229) was entered on July 2, 1947. The petition for a writ of certiorari was filed on October 1, 1947. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the recovery in the taxable year of an amount taken as a bad debt deduction in a prior year with tax benefit resulted in ordinary income taxable in full under Section 22 (a) of the Internal Revenue Code, or whether it may be treated as a capital gain, taxable at capital gain rates under Section 117 of the Code.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set out in the Appendix, *infra,* pp. 11–17.

STATEMENT

In the present application, certiorari is sought only with respect to one of the issues in controversy before the Tax Court (R. 122–124, 138–140), and before the court below (R. 223–225), namely, as to whether the amount of $47,431.04 realized by the Joe A. Humphrey Company partnership in the taxable year 1941, upon notes with respect to which a bad debt deduction had been taken in

a prior year, constituted ordinary income—rather than capital gain—includible pro rata in the taxable income of the partners and their respective spouses, the petitioners herein (Pet. 1–2, 8; R. 118–119).

The facts with respect to that issue, as found by the Tax Court (R. 122–124), may be summarized as follows:

On January 1, 1941, the partnership, the Joe A. Humphrey Company, held notes executed by the Ellis Petroleum Company in the aggregate face amount of $63,758.25. Its entire investment in those notes, amounting to $42,200, had been charged off by it in 1939 as worthless and uncollectible, with a resulting tax benefit. (R. 122.)

On December 15, 1939, a court proceeding was filed for the reorganization of the Ellis Petroleum Company, and the partnership filed therein a proof of its claim for the indebtedness of $63,758.25, which proof of claim was allowed and adjudged to constitute a second lien on the property of the bankrupt, inferior only to administrative expenses and court costs and the lien of a bank, and to be of equal dignity and on a parity with the lien securing a claim of McClanahan & Venable, whose claim was allowed in the amount of $45,725.16 (R. 122–123).

On September 5, 1941, the referee in bankruptcy ordered the sale at public auction of certain property of the bankrupt. At the sale, on October

15, 1941, the property was bid in by the Humphrey partnership and McClanahan & Venable, jointly, for a final bid price of $160,000. The sale was subsequently confirmed, and the bidders (in addition to making certain cash payments with respect to the superior lien of the bank, not here material) were allowed as a credit towards the purchase price the sum of $79,051.73 on account of their notes and liens for that amount. On December 3, 1941, the property was conveyed to Joe A. Humphrey to the extent of 60 percent, and to McClanahan & Venable to the extent of 40 percent. The face amount of notes of Ellis Petroleum Company in the total amount of $79,051.73 which were collected in this transaction were allocable $47,431.04 to the Humphrey partnership and $31,620.69 to McClanahan & Venable. (R. 123–124.)

The notes in question had been held by the Humphrey partnership for more than 24 months (R. 124).

The Commissioner has included in the respective gross incomes of the petitioners for the year 1941 their pro rata share of the $47,431.04[2] credit

[2] In his determination (R. 27, 48, 66, 85, 104–105), the Commissioner had taken as the amount includible in the gross income of the partnership and of the petitioners the sum of $63,758.25—which sum represents the aggregate face amount of Ellis Petroleum Company notes held by the partnership (R. 122). However, before the Tax Court (R. 138), he conceded that the amount includible in gross income with

given the partnership in connection with the purchase of the Ellis Petroleum Company properties on account of the notes written off and allowed as a deduction in a prior year, with tax benefit (R. 27, 48, 66, 85, 104–105).

In the Tax Court, the petitioners, conceding that the transaction resulted in income to the partnership in the amount of $47,431.04, claimed only that the $47,431.04 constituted capital gain, instead of ordinary income (R. 117, 138). The Tax Court, sustaining the Commissioner, held that the amount in question was taxable as ordinary income (R. 138–140).

The court below affirmed the decision of the Tax Court on this issue (R. 223–225).

ARGUMENT

The court below correctly affirmed the decision of the Tax Court upholding the Commissioner's position that the $47,431.04 credit received by the partnership in the taxable year with respect to the notes constituted ordinary income, taxable pro rata to the petitioners. The partnership's entire cost of $42,200 for all of the notes had been charged off and deducted in 1939, with tax benefit. In 1941, it realized $47,431.04 by reason of the application of notes of a face value in that

respect to the notes was only $47,431.04—which amount represents the partnership's portion of the total amount of notes allowed as a credit towards the purchase price of the property at the sale (R. 124).

amount towards the purchase price of the property, which must be regarded as being worth not less than the bid amount. (R. 140, 224–225.) The $47,431.04 was admittedly taxable income, as conceded before the Tax Court (R. 138) and before the court below (R. 224). In this Court (Pet. 14, Br. 20), the only question raised is whether, instead of being taxable in full as ordinary income, it may be treated as capital gain, taxable at capital gain rates.

1. The Tax Court upheld the taxation of the amount as ordinary income upon the theory that, to the extent of the amount of $42,200 previously charged off and deducted as a bad debt in 1939,[3] the result of the transaction in 1941 constituted the recovery of an amount previously deducted as a bad debt with tax benefit and was therefore to be treated as ordinary income. The amount of a recovery during the taxable year on account of a bad debt deduction taken in a prior year must be included in gross income in the year of recovery, under Treasury Regulations 103, Sections 19.23 (k)–1 and 19.42–1 (Appendix, *infra*, pp. 16–17).[4]

[3] The treatment of the remaining $5,231.04 is discussed *infra*, pp. 9–10.

[4] Provisions with respect to the recovery of bad debts similar to those contained in Sections 19.23 (k)–1 and 19.42–1 of Regulations 103 have appeared, respectively, as far back as in Article 151 of Regulations 65, promulgated under the Revenue Act of 1924, and in Article 51 of Regulations 62, promulgated under the Revenue Act of 1921.

Such recovery has repeatedly and consistently been held to be includible in gross income as ordinary income and not as capital gain; the propriety of such treatment follows from the fact, pointed out by the Tax Court (R. 139), that the charge-off of the debt in the prior year constitutes an offset to ordinary income. See *Putnam National Bank* v. *Commissioner,* 20 B. T. A. 45, affirmed, 50 F. 2d 158 (C. C. A. 5th). See also *National Bank of Commerce of Seattle* v. *Commissioner,* 40 B. T. A. 72, affirmed on another point, 115 F. 2d 875 (C. C. A. 9th), and *Central Loan & Investment Co.* v. *Commissioner,* 39 B. T. A. 981. Inclusion in gross income in the taxable year of the bad debt previously charged off and deducted with tax benefit is in keeping with Section 22 (b) (12) of the Internal Revenue Code, as amended retroactively by the Revenue Act of 1942 (Appendix, *infra,* pp. 11–13), which permits the exclusion from gross income only of bad debt recoveries with respect to which there has been no deduction with tax benefit in a prior year. For the Committee reports on this provision seem to assume that the amount which is not excludible from gross income under that amendment—namely, the amount of the bad debt recovery as to which there had been a deduction with tax benefit in a prior year—must be includible in gross income as ordinary income. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 69–71 (1942–2

765509—47——2

Cum. Bull. 372, 426–427), and S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 79–80 (1942–2 Cum. Bull. 504, 565–566). Under the circumstances, the Tax Court properly approved the taxation as ordinary income of the partnership's "recovery" on the notes in the taxable year to the extent of $42,200, for which there had been a deduction with tax benefit in a prior year, and the court below correctly affirmed that decision.

There is no merit to the petitioners' contention (Pet. 13–15, 21–24) that this decision of the court below ignores the provisions of Section 19.23 (k)–3 of Treasury Regulations 103 (Appendix, *infra*, pp. 16–17) and is in conflict with *Nichols* v. *Commissioner*, 141 F. 2d 870 (C. C. A. 6th), and *Hadley Falls Trust Co.* v. *United States*, 110 F. 2d 887 (C. C. A. 1st). Briefly, Section 19.23 (k)–3 of the Regulations provides that if the mortgaged property is bought at the sale by the mortgagee, the mortgagee may have a bad debt deduction for the excess of the mortgage indebtedness (up to his cost) over the bid price, and, in addition, he realizes gain or loss in the amount of the difference between the amount of the mortgage obligations applied to the bid price and the fair market value of the property, which is presumed to be the bid price in the absence of proof to the contrary.[5] In the instant case, the property

[5] For an illustration of the manner of computing the mortgagee's bad debt and gain or loss, see I. T. 3159, 1938–1 Cum. Bull. 188.

was worth the bid price (R. 140, 224–225), upon the basis of which the partnership income taxable to the petitioners has been computed; this fact makes it obvious that the decision below does not ignore the provisions of the Regulations insofar as the determination of *the amount* of the mortgagee's income is concerned. The fact that the property in this case was worth the bid price is also a complete answer to the claim that the decision below is in conflict with *Nichols* v. *Commissioner, supra,* or *Hadley Falls Trust Co.* v. *United States, supra,* which held that the fair market value of the property (and not the bid price) is controlling in determining the mortgage creditor's income. See *Malden Trust Co.* v. *Commissioner,* 110 F. 2d 751 (C. C. A. 1st). With respect to *the character* of the mortgagee's income, namely, whether capital gain or ordinary income, this provision of the Regulations is inapplicable in this case and lends no support to the petitioners' claim that the income constituted capital gain, because, as already pointed out, the taxing as ordinary income of the $47,431.04 realized by the partnership on the notes in the taxable year is justified and proper to the extent of $42,200 as the recovery of a bad debt.

2. As to the difference ($5,231.04) between the $42,200 previously charged off and the $47,431.04 credit received on the notes in the taxable year, the Tax Court upheld its inclusion in income as ordinary income upon the theory that such dif-

ference could be interest, as contended by the Commissioner upon the authority of *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, although recognizing that if facts sufficient to establish it had been shown, the difference might be treated as capital gain (R. 139–140). Upon the record, the decision of the Tax Court upon this phase of the case is likewise correct and was properly affirmed by the court below, which stated that it could not say (R. 225)—

> that the $5,431 realized beyond the $42,200 agreed original investment in them all is other than ordinary gain, perhaps interest which the notes earned on their true consideration. * * *

CONCLUSION

The decision below is correct. It turns upon the particular facts of the case and presents no question calling for review by this Court. There is no conflict of decisions. The petition should, therefore, be denied.

Respectfully submitted.

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OCTOBER, 1947.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) [As amended by Section 116 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] [6] *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(12) *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such

[6] Subsection 12, which was added to Section 22 (b) of the Internal Revenue Code by Section 116 (a) of the Revenue Act of 1942, was made applicable by Section 116 (b) of the 1942 Act with respect to taxable years beginning after December 31, 1938.

debt, tax, or amount. For the purposes of this paragraph:

(A) *Definition of Bad Debt.*—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) *Definition of Prior Tax.*—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(C) *Definition of Delinquency Amount.*—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

(E) *Special Rules in Case of Section 102 Tax and Personal Holding Company Tax.*—In the application of subparagraphs

(A), (B), (C), and (D) in determining the tax under section 102 or Subchapter A of Chapter 2, a recovery exclusion allowed for the purposes of Chapter 1 shall be allowed for the purpose of such section or subchapter whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the section 102 tax or Subchapter A tax for the prior taxable year; and in the case of a bad debt, prior tax, or delinquency amount not allowable as a deduction or credit for the prior taxable year under Chapter 1 (except section 102) but allowable for the same taxable year under such section or subchapter a recovery exclusion shall be allowable for the purposes of such section or subchapter if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under such section 102 or such Subchapter A. As used in this subparagraph references to Chapter 1, section 102, and Subchapter A in the case of taxable years not subject to the Internal Revenue Code, shall be held to be made to corresponding provisions of prior revenue Acts.

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the

ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

* * * * *

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

(26 U. S. C. 1940 ed., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (b) (12)–1 [as amended by T. D. 5288, 1943 Cum. Bull. 103]. *Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts.*—(*a*) *In general.*—Section 22 (b) (12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. In substance, the recovery exclusion is an amount equal to the portion of such items which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer

under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

(1) *Section 22 (b) (12) items.*—Bad debts, prior taxes, and delinquency amounts are defined in section 22 (b) (12) (A), (B), and (C), respectively. A typical example of a delinquency amount described in that section is interest upon delinquent taxes. The bad debts, prior taxes, and delinquency amounts referred to in that section, called "section 22 (b) (12) items" in this section, are only those for which a deduction or credit was allowed for a prior taxable year. Thus, if a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22 (b) (12) item.

(2) *Definition of "recovery."*—Recoveries result from the receipt of amounts in respect of the previously deducted or credited items described in section 22 (b) (12), such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 22 (b) (12), that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 22 (b) (12) item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery." Furthermore, the term "recovery" does not

include the gain resulting from the receipt of an amount on account of a section 22 (b) (12) item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 22 (b) (12) item. Such gain is in no case excluded from gross income under section 22 (b) (12), regardless of whether the $40 recovery is or is not excluded.

* * * * *

SEC. 19.23 (k)–1. *Bad debts.*—(a) Bad debts may be treated in either of two ways—

(1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, or

* * * * *

(b) If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. * * *

* * * * *

SEC. 19.23 (k)–3. *Uncollectible deficiency upon sale of mortgaged or pledged property.*—If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the

indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

* * * * *

SEC. 19.42–1. *When included in gross income.*—* * * Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. (See section 19.23 (k)–1.)

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